Journal of International Accounting, Auditing and Taxation 26 (2016) 28–46

Contents lists available at ScienceDirect

Journal of International Accounting, Auditing and Taxation

The effect of corporate governance, auditor choice and global activities on EU company disclosures of estimates and judgments

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ARTICLE INFO

Article history:
Available online 5 March 2016

Keywords:
IFRS
Estimates
Judgments
Disclosure
IAS 1
Big-4 auditor

ABSTRACT

Following the 2005 EU adoption of IFRS, several studies noted that some companies omitted a separate disclosure of key judgments and estimation uncertainty within the notes to the financial statements, and other companies limited their separate disclosure to boilerplate narrative. We determine if the choice of specific Big-4 audit firm and the independent variables included in the international financial reporting literature associated with voluntary disclosure are related to the decision to include a separate disclosure of judgments and estimates that provides more than boilerplate narrative. We also test if these independent variables affect the qualitative characteristics of the separate disclosures. We find that several of our independent variables are significant in the decision to make a disclosure that contains more than boilerplate, and affect the length and content of the separate disclosure. These findings add to the literature by identifying factors that influence discretionary disclosure. Our study also contributes to the current financial statement disclosure discussion among standard setters and regulators by detailing the format and content of disclosures among a sample of EU companies. This is an important area of inquiry, given that prior research finds that the way information is displayed affects how that information is actually used.

1. Introduction and theoretical development

During 2007 and 2008, two professional accounting bodies and one public accounting firm published descriptive studies that analyzed either European Union (EU) or United Kingdom (UK) company compliance with the requirements of International Accounting Standard 1 (IAS 1) following the 2005 mandatory adoption of IFRS within the EU. These studies reported that at least some companies did not include a separate disclosure of the estimates and judgments underlying their reported results. For those companies that did provide a separate disclosure, the disclosure was often less than informative, failed to include information about the sensitivity of the reported numbers to the assumptions underlying their calculation, and provided little quantitative information useful to financial statement readers (Deloitte & Touche LLP, 2007, 2008; ICAEW, 2007; FRC & FRRP, 2008).

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http://dx.doi.org/10.1016/j.intaccaudtax.2016.02.002
1061-9518/

IAS 1 does not require a separate presentation of the judgments, key assumptions, or sources of estimation uncertainty underlying the results presented in financial statements. Rather, IAS 1 stipulates that this information should be disclosed "in the summary of significant accounting policies or other notes" (IASB, 2003, 113). As a result, a company may comply with the requirements of IAS 1 either by (1) presenting a separate disclosure of judgments and estimation uncertainty as they affect specific accounting topics within the financial statement notes, (2) presenting a separate, brief explanation of the use of judgments and estimates with the details contained within other account-specific footnote disclosures, or (3) omitting a separate disclosure and instead providing all information regarding judgments and estimates within footnotes pertaining to specific accounts. The content of the disclosure, if separately presented, is subject to management's discretion in determining those judgments that have the most significant effect on the financial statements and the key assumptions and estimates "that have a significant risk of causing a material adjustment in the carrying amounts of assets and liabilities within the next financial year" (IASB, 2003, 116).

We differentiate between those companies that either did not separately disclose or limited their disclosures to boilerplate, versus those that provided a separate disclosure that included both topics and subjects. We define boilerplate as verbiage that is largely uninformative and typically found in the disclosures of unrelated companies. This definition is consistent with recent disclosure surveys (e.g., FRC & FRRP, 2010).

Our distinction is consistent with prior studies (Deloitte & Touche LLP, 2007, 2008; ICAEW, 2007) that differentiated between those companies that either did not separately disclose or limited their separate disclosures to non-descriptive boilerplate, versus those companies that provided a separate disclosure that identified specific accounting topics (financial statement line items) and relevant subject information. We believe that a separate disclosure that includes detailed information about the impact of estimates and judgments on reported results of specific accounting topics is preferable to other forms of disclosure. This presumption is consistent with prior research that finds simple reformatting of information available elsewhere in the financial statement disclosures improves financial analysts' judgments (Russo, Krieser, & Miyashita, 1975; Johnson, Payne, & Bettman, 1988). Drawing from agency theory and prior literature as to how information is efficiently processed, we assume that a meaningful separate disclosure of estimates and judgments provides users with decision-relevant information. This assumption is consistent with recent comments about the importance of clearly identifying estimates and judgments within financial statement disclosures (EFRAG, 2012; FASB, 2012; FRC & FRRP, 2011; KPMG, 2011).

Voluntary disclosure, as a means of attenuating agency costs, has been shown to vary with corporate governance structure, selection of audit firm, and global activities (Jensen & Meckling, 1976; Forker, 1992; Eng & Mak, 2003; Xiao, Yang, & Chow, 2004). Based on these findings and those in other streams of the voluntary disclosure literature, we hypothesize that board independence, choice of specific Big-4 auditor, and extent of global activities is associated with a greater probability that a company will provide a separate disclosure that includes both account titles and the nature of the estimates and judgments that impact the results presented in the financial statements. We refer to these disclosures as more than boilerplate (MORETHANBP) disclosures within this paper.

We further hypothesize that the qualitative characteristics (e.g., the number of sentences, number of accounting topics, and number of financial statement footnote references) of the separate disclosures are related to the three sets of independent variables identified above. We conceptualize the number of sentences as a measure of the extent or size of the disclosure. We view the number of topics and footnote references as a measure of the varied nature or richness of the disclosures.

We find that the probability of a company providing MORETHANBP, as compared with companies that make no disclosure or a disclosure limited to boilerplate, is related to auditor choice. When the sample is limited to those companies that provide only boilerplate (BPONLY), auditor choice affects the probability that a company lists key accounting topics or identifies specific note references within that boilerplate disclosure. We find that disclosure length is related to having a U.S. listing; that the number of note references are related to Big-4 auditor choice, and that the number of accounting topics cited are related to global activities. Further, we find that the choice of Big-4 auditor is related to the percentage of sentences devoted to either judgments or estimates, that foreign activity influences the sentences devoted to uncertainties described as "estimates and judgments", as well as the percentage of sentences describing the sensitivity of the financial statement accounts to the estimates.

Our study contributes to the voluntary literature in several ways. First, our study is the first to examine the influence of corporate governance on disclosures of critical estimates and judgments in the financial statement footnotes. By examining auditor effects among the Big-4 audit firms, our study contributes to the small body of prior literature that indicates auditor effects on disclosure format and content across the largest audit firms are not as homogenous as previously believed. We add to the body of literature that finds companies with multiple listings, including being listed in the US, make more voluntary disclosures. We provide further evidence that the extent of disclosure is positively related to the level of globalization within the company's operating activities. In addition, our study contributes to the body of literature that examines the ordering or physical location of information as a means of emphasizing specific items of information, and provides input into the current disclosure projects undertaken by standard setters and regulators. The findings are based on the separate disclosures of estimates and judgments of 147 companies across 35 industries and 24 EU countries, a broader sample than that found in many prior studies.

The remainder of the paper is organized as follows. In Section 2 we expand the background on IAS 1 disclosures of estimates and judgments, summarize the literature on voluntary disclosure, and develop the hypotheses. In Section 3 we describe the sample selection, explain the data collection, and define the independent and dependent variables. Section 4 presents the study's results; the analysis and conclusion is found in Section 5.